

Audit

Report



COMPILATION PROCESS FOR THE DOD CONSOLIDATED
FINANCIAL STATEMENTS FOR FY 1997

Report Number 98-210

September 24, 1998

Office of the Inspector General
Department of Defense

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Acronyms

| | |
|--------|--|
| CFO | Chief Financial Officers |
| DFAS | Defense Finance and Accounting Service |
| OMB | Office of Management and Budget |
| USD(C) | Under Secretary of Defense (Comptroller) |



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

September 24, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on the Compilation Process for the DoD Consolidated
Financial Statements for FY 1997 (Report No. 98-210)

We are providing this report for review and comments. We reviewed the compilation process for the DoD Consolidated Financial Statements for FY 1997.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. We request that the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, provide comments on the recommendations by November 23, 1998.

We appreciate the courtesies extended to the audit staff. If you have any questions, please contact Mr. Richard B. Bird, at (703) 604-9175 (DSN 664-9175), e-mail rbird@dodig.osd.mil or Mr. Jack L. Armstrong, at (317) 510-3846 (DSN 699-3846), e-mail jarmstrong@dodig.osd.mil. If management requests, we will provide a formal briefing on the audit results. See Part II, Appendix D, for the report distribution. A list of audit team members is included on the inside of the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-210
(Project No. 7FI-2030.04)

September 24, 1998

Compilation Process for the DoD Consolidated Financial Statements for FY 1997

Executive Summary

Introduction. This is the fourth and final in a series of reports related to the FY 1997 DoD Consolidated Financial Statements. The first report discussed internal controls and compliance with laws and regulations for the financial statements. The second report discussed the reporting of operating materials and supplies and inventory in the financial statements. The third report discussed the reporting and disclosing of intragovernmental transactions in the financial statements.

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD and other Federal agencies to prepare audited financial statements annually. The Federal Financial Management Act of 1994 requires the Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, to prepare Government-wide financial statements beginning in FY 1997. Office of Management and Budget and DoD Guidance on Form and Content of Audited Financial Statements requires that amounts reported in the footnotes be consistent with amounts reported as line items of the principal financial statements. In addition, financial information reported in multiple footnotes should be reported consistently throughout the financial statements. The Statement of Financial Position reported total assets of \$1.33 trillion and total liabilities of \$949 billion for FY 1997. On February 27, 1998, we issued a disclaimer of opinion on the DoD Consolidated Financial Statements for FY 1997. We issued our report on internal controls and compliance with laws and regulations on June 22, 1998.

Audit Objectives. The overall audit objective was to determine whether the DoD Consolidated Financial Statements for FY 1997 were presented fairly in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996.

Our specific audit objective was to review the compilation process for the DoD Consolidated Financial Statements at the Defense Finance and Accounting Service Indianapolis Center and to determine whether DoD consistently, accurately, and completely reported financial statement information. We also assessed internal controls and compliance with laws and regulations and evaluated the management control program for the compilation of the DoD Consolidated Financial Statements.

Audit Results. The compilation process for the DoD Consolidated Financial Statements for FY 1997 did not result in consistent, accurate, nor complete financial statement information. Specifically, we identified the following anomalies valued at \$395.1 billion:

- large unexplained variances between reporting years totaling \$329 billion;
- inconsistencies between footnotes and line items totaling \$48.1 billion;
- inconsistencies between comparative years totaling \$16.2 billion;
- inconsistencies between footnotes totaling \$1.5 billion; and
- inaccurate classification of assets and liabilities totaling \$0.3 billion.

The inconsistent reporting has been a recurring problem in the compilation process for the DoD Consolidated Financial Statements for FY 1996 and FY 1997. As a result, the DoD Consolidated Financial Statements for FY 1997 were misstated by \$10.8 billion and confusing. In addition, the understatement of environmental liabilities at the DoD level caused material misstatements in the Government-wide, "1997 Consolidated Financial Statements of the United States." See Part I for details and Appendix A for our review of the management control program.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) develop specific guidelines and procedures for reconciling financial information to ensure consistent reporting between footnotes and financial statements, include those guidelines and procedures in the next update to the DoD guidance on the Form and Content of Audited Financial Statements, and provide the guidance to the DoD Components' at least 90 days prior to the beginning of each fiscal year. We recommend that the Director, Defense Finance and Accounting Service, verify that the necessary reconciliations are performed and documented at each reporting level by the Defense Finance and Accounting Service Centers to ensure consistent, accurate, and complete reporting in the financial statements each fiscal year; verify that large variances in financial statement line-items from year-to-year are fully explained in the financial statement footnotes; and ensure that the necessary timelines for financial reporting are met each fiscal year.

Management Comments. The Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, did not respond to a draft of this report. We request that the Under Secretary of Defense (Comptroller) and Director, Defense Finance and Accounting Service, comment on this audit report by November 24, 1998.

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Part I - Audit Results

Audit Background

This is the fourth and final in a series of reports related to the FY 1997 DoD Consolidated Financial Statements. The first report discussed internal controls and compliance with laws and regulations for the financial statements. The second report discussed the reporting of operating materials and supplies and inventory in the financial statements. The third report discussed the reporting and disclosing of intragovernmental transactions in the financial statements.

Chief Financial Officers Act. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD and other Federal agencies to prepare audited financial statements annually. In addition, the Federal Financial Management Act of 1994 requires the Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, to prepare Government-wide financial statements beginning in FY 1997.

Accounting Functions and Responsibilities. The Under Secretary of Defense (Comptroller) [USD(C)], as the Chief Financial Officer (CFO) of DoD, is responsible for overseeing the preparation of agency-wide financial statements and establishing financial management policies and guidelines within DoD. Day-to-day operations of the reporting entities are the responsibilities of the Military Departments, the Defense agencies, and DoD field activities. The Defense Finance and Accounting Service (DFAS) performs accounting functions and prepares financial statements for DoD. DFAS, the USD(C), and the DoD Components are responsible for the DoD financial statements. DFAS operates under the control and direction of the USD(C). DFAS is responsible for entering information from DoD entities into financial systems, operating and maintaining the financial systems, and ensuring the continued integrity of the information entered. DoD entities are responsible for providing accurate financial information to DFAS.

Financial Statement Compilation. The DFAS Indianapolis Center compiles the DoD Consolidated Financial Statements based on financial statement data for the DoD Components' provided by the other DFAS centers. The DoD Consolidated Financial Statements for FY 1997 consist of the financial statements of the Army, the Navy, and the Air Force General Funds; the Army, the Navy, and the Air Force Working Capital Funds; the Defense Logistics Agency, the Defense Information Systems Agency, the DFAS, the Defense Commissary Agency, the U.S. Transportation Command, and the Joint Logistics Systems Center Working Capital Funds; the DoD Military Retirement Trust Fund; the National Defense Stockpile Transaction Fund; the U.S. Army Corps of Engineers (Civil Works); and the Other Defense Organizations General Fund.* DoD did not include financial data for the Defense Security Assistance Agency in the DoD Consolidated Financial Statements.

For FY 1997, the DoD Consolidated Statement of Financial Position reported assets of \$1.33 trillion and liabilities of \$949 billion. The DoD Consolidated Statement of Operations and Changes in Net Position reported revenues of \$270 billion and expenses of \$295 billion.

*DoD did not prepare financial statements for the Other Defense Organizations General Fund; however, accounting data for that fund is part of the DoD Consolidated Financial Statements.

Audit Objectives

The overall audit objective was to determine whether the DoD Consolidated Financial Statements for FY 1997 were presented fairly in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. We also assessed internal controls and compliance with laws and regulations and evaluated the management control program for the compilation of the DoD Consolidated Financial Statements. On February 27, 1998, we issued a disclaimer of opinion on the DoD Consolidated Financial Statements for FY 1997. Our report on internal controls and compliance with laws and regulations was issued June 22, 1998.

Our specific audit objective was to review the compilation process for the DoD Consolidated Financial Statements at the DFAS Indianapolis Center and determine whether DoD consistently, accurately, and completely reported financial statement information. We also evaluated the management control program for the compilation of the DoD Consolidated Financial Statements. See Appendix A for a discussion of the scope and methodology related to the audit objectives. Appendix B discusses the results of prior audit coverage.

Compilation Process

The compilation process for the DoD Consolidated Financial Statements for FY 1997 did not result in consistent, accurate, or complete financial reporting. Specifically, we identified the following anomalies valued at \$395.1 billion:

- large unexplained variances between reporting years totaling \$329 billion;
- inconsistencies between footnotes and line items totaling \$48.1 billion;
- inconsistencies between comparative years totaling \$16.2 billion;
- inconsistencies between footnotes totaling \$1.5 billion; and
- inaccurate classification of assets and liabilities totaling \$0.3 billion.

Inconsistent reporting has been a recurring problem in the compilation process for the DoD Consolidated Financial Statements for FY 1997 and FY 1996. Inconsistent, inaccurate, and incomplete reporting occurred because DoD Form and Content Guidance was not adequate for preparing and compiling the financial statements and was not timely; DFAS did not perform adequate reviews to ensure consistency throughout the financial statements; and DFAS did not implement existing policy regarding footnote disclosure. As a result, the DoD Consolidated Financial Statements for FY 1997 were misstated by \$10.8 billion and unclear. In addition, the understatement of environmental liabilities at the DoD level caused material misstatements in the Government-wide, "1997 Consolidated Financial Statements of the United States."

Financial Reporting Guidance

OMB Guidance on Form and Content. OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," as supplemented by OMB Bulletin No. 97-01, defines the form and content of financial statements of executive departments and agencies that must be submitted to the Director of the OMB pursuant to the requirements of the CFO Act of 1990. The notes to the principal statements are an integral part of those statements and must provide additional disclosures necessary to make the principal statements fully informative and not misleading. Amounts reported in the footnotes should be consistent with amounts reported as line items of the principal statements. The OMB Bulletin No. 94-01, which was effective through FY 1997, does not address intrafund eliminations. However, OMB Bulletin No. 97-01, requires agencies to show consolidated financial statements adjusted for intra-entity eliminations for FY 1997.

Financial Accounting Standards Boards Accounting Standards. Financial Accounting Standards Board Accounting Standards, "Financial Statements:

Comparative Financial Statements," June 1, 1995, states that prior year figures shown for comparative purposes be comparable with those shown for those for the most recent period, or that any exceptions to comparability be clearly brought out.

DoD Guidance on Form and Content. Defense Financial Management Regulation, DoD Regulation 7000.14-R, volume 6, chapter 6, "Form and Content of Audited Financial Statements," provides guidance on the form and content of financial statements to be prepared under the authority of the CFO Act and OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," as modified by OMB Bulletin No. 97-01. The DoD form and content guidance is intended to provide a framework within which each DoD Component has the flexibility to develop and include information useful to its financial managers and program managers in making decisions. Program managers must submit unaudited financial statements to the CFO by December 18th following the fiscal year end. The DoD form and content guidance requires that amounts reported in the footnotes be consistent with amounts reported as line items of the principal statements.

DFAS Guidance. DFAS provided additional guidance on FY 1997 CFO reporting to the DFAS centers on October 27, 1997. This guidance stated that the DFAS centers should verify that all amounts reported on financial statements are correct and presented in accordance with DoD accounting guidance and the DoD form and content guidance. Specifically, the DFAS centers were required to identify material variances between accounts between fiscal years. Any material variances were to have been corrected or explained in the financial statement footnotes. In addition, the DFAS centers were required to verify that all financial statements are complete and that information is reported consistently.

Other Guidance. IG, DoD, Report No. 96-161, "Compilation of FY 1995 and FY 1996 DoD Financial Statements at the Defense Finance and Accounting Service, Indianapolis Center," June 13, 1996, assessed whether DFAS consistently and accurately compiled financial data for the Consolidated Financial Statements for the Army General Fund for FY 1995. The report identified instances where the footnotes did not fully explain large variances in financial statement line-items from year-to-year and recommended that the Director, DFAS, develop and implement procedures for fully explaining these variances. The Director, DFAS, concurred with the recommendation and stated that in future years, DFAS planned to include explanations for large variances* in financial statement line-items from year-to-year, which are not the result of normal operations, in the footnotes.

Consistency, Accuracy, and Completeness of Financial Statement Information

The DoD did not consistently or accurately report \$395.1 billion in financial statement information in the DoD Consolidated Financial Statements for FY 1997. The DoD also reported inconsistent financial statement information in the DoD Consolidated Financial Statements for FY 1996.

* For the Army General Fund, the Director, DFAS, informally agreed that variances from year-to-year where the change is greater than \$500 million and at least 25 percent should be explained in the financial statement footnotes.

Compilation Process

The FY 1996 inconsistencies were identified in IG, DoD, Report No. 97-182, "Internal Controls and Compliance With Laws and Regulations for the DoD Consolidated Financial Statements for FY 1996."

Since Report No. 97-182 was a summary of other reports on internal controls and compliance with laws and regulations prepared by the IG, DoD, and the Military Department audit agencies, the report made no recommendations for corrective action. Following is a discussion of the inconsistent and inaccurate reporting we identified on the DoD Consolidated Financial Statements for FY 1997.

Consistency Between Footnotes. Financial information reported in multiple footnotes should be reported consistently so as not to confuse users of the financial statements. The footnotes to the DoD Consolidated Financial Statements for FY 1997 did not consistently report \$1.5 billion in financial information. For example:

- **Note 1, Summary of Significant Accounting Policies.** Note 1 stated that DoD valued inventory at a standard sales price; however, Note 24, Cost of Goods Sold, which also addresses inventory methodology, reported that inventory was valued at the latest acquisition cost.
- **Note 17, Other Liabilities.** Note 17 reported total advances and unearned revenues of \$3.4 billion; however, Note 29, Intrafund Eliminations, which identifies total advances and unearned revenues for elimination purposes, reported \$1.9 billion in total advances and unearned revenues. The \$1.5 billion difference was not explained in the financial statements.

These inconsistencies could confuse users of financial statements regarding how DoD values inventory and the amount of advances and unearned revenue that DoD is reporting.

Footnote Consistency With Line Items. DoD did not consistently report \$48.1 billion between the footnotes and corresponding line items of the DoD Consolidated Financial Statements for FY 1997, in accordance with OMB and DoD Form and Content guidance. We identified the following inconsistencies:

- **Note 15, Property, Plant, and Equipment.** The FY 1996 Military Equipment account balance included in the DoD Consolidated Financial Statements for FY 1997 for comparative purposes was understated by \$20.1 billion. The Navy reported in Note 15 of its financial statements that it had understated its FY 1996 Military Equipment account balance by \$20.1 billion and that this amount was included in the FY 1997 account balance for Military Equipment. However, the Navy did not make a prior-period adjustment to the FY 1996 amount so that the FYs 1996 and 1997 financial statements and footnotes would show comparable data.
- **Note 17, Other Liabilities.** DoD did not consistently and completely report all environmental liabilities in the Consolidated Financial Statements. The Army misreported \$15.1 billion of environmental cleanup costs and \$10.5 billion of chemical demilitarization costs under the subcategory "Other" instead of the subcategory "Environmental Cleanup Costs" in the Army General Fund Financial Statements. In a note to Note 17 of the DoD Consolidated Financial Statements, DFAS recognized as

environmental liabilities the \$15.1 billion of environmental cleanup costs misreported by the Army. However, DFAS did not recognize as environmental liabilities the additional \$10.5 billion of chemical demilitarization costs misreported by the Army. Thus, DoD understated total environmental liabilities by \$10.5 billion.

- **Note 24, Cost of Goods Sold.** The amounts reported for intragovernmental cost of goods sold and cost of goods sold to the public were not supported by Note 24. Note 24 reported only the total cost of goods sold and stated that the amount was prorated between the intragovernmental cost of goods sold and cost of goods sold to the public, based on revenues generated, but did not provide the calculations or the amounts.
- **Note 25, Other Expenses.** Material differences existed between the other expenses disclosed in Note 25 and related line items on the Consolidated Financial Statements. In preparing Note 25, DFAS used \$4.1 billion for changes in actuarial liabilities for the Military Retirement Trust Fund. However, the Military Retirement Trust Fund reported \$15.9 billion for changes in actuarial liabilities and DFAS used the \$15.9 billion amount when consolidating the DoD Components' financial statements. The \$11.8 billion difference between the amount reported in Note 25 and the related line item on the financial statement was due to the misclassification of an \$11.8 billion intragovernmental elimination on the Statement of Operations and Changes in Net Position by DFAS.
- **Note 29, Intrafund Eliminations.** Material differences existed between the revenue amounts disclosed in Note 29 and the revenue line item on the Consolidated Financial Statements. Note 29 identified \$17.4 billion of revenue, however, the revenue line item on the Statement of Operations and Changes in Net Position showed \$23.1 billion. DoD did not explain the \$5.7 billion difference.

The inconsistent reporting of FY 1996 financial information in the FY 1997 financial statements could confuse users of financial statements regarding DoD property, plant, and equipment balance. Reporting inconsistencies could confuse users of financial statements about the changes in actuarial liabilities, the amount of DoD environmental liabilities, and the amount of revenue DoD reported and eliminated.

Additional Reporting Issues. The DoD Consolidated Financial Statement for FY 1997 did not accurately classify \$0.3 billion of assets and liabilities in Note 17 and did not consistently report \$16.2 billion of FY 1996 comparative balances in other footnotes. We identified the following issues:

- **Accurate Classification of Assets and Liabilities.** The footnotes did not classify assets and liabilities accurately. For example, Note 17 included \$0.3 billion (absolute value) of accounts receivable, an asset line-item, although Note 17 should have included only other liabilities. This misclassification overstated the Other Liabilities (Intragovernmental) Covered by Budgetary Resources that DoD reported by \$312 million and understated the Other Liabilities (Governmental) Covered by Budgetary Resources that DoD by \$29.4 million.

Compilation Process

- **Consistency Between Comparative Years.** FY 1996 comparative balances reported in the footnotes of the DoD Consolidated Financial Statements for FY 1997 were not always consistent with financial data reported in the footnotes of the DoD Consolidated Financial Statements for FY 1996. We identified a total of \$16.2 billion in differences. These differences are summarized in Appendix C. For example, \$15 billion of the total differences identified were inconsistencies in how inventory losses or adjustments and transfer to property disposal amounts were reported. The \$15 billion differences in inventory losses or adjustments and transfer to property disposal did not cause the related financial statements line item, Other Expenses, to be misstated. However, DFAS provided no explanation of the inconsistencies between the financial data reported in the footnotes of the DoD Consolidated Financial Statements for FY 1996 and the FY 1996 comparative balances reported in the footnotes of the DoD Consolidated Financial Statements for FY 1997.

Complete Reporting of Financial Statement Information. Large variances in financial statement line-items existed from year-to-year in the DoD Consolidated Financial Statements for FY 1997. For the purposes of our review, we defined large variances as those that exceeded \$10 billion (roughly, the materiality level for the DoD Consolidated Financial Statements) and were at least 25 percent variance in line item from one year to the next. The variances we identified were not explained in the financial statement footnotes. Specifically, we identified the following three variances, totaling \$329 billion (absolute value):

- **Pensions and Other Actuarial Liabilities.** Line 5.b.4, Pensions and Other Actuarial Liabilities, of the DoD Consolidated Statement of Financial Position for FY 1997 showed a balance of \$726.4 billion, a \$304.5 billion (72.1 percent) increase over the FY 1996 balance of \$421.9 billion.
- **Other Non-Federal (Governmental) Liabilities.** Line 5.b.5, Other Non-Federal (Governmental) Liabilities, of the DoD Consolidated Statement of Financial Position for FY 1997 showed a balance of \$37.6 billion, a \$13.4 billion (54.9 percent) increase over the FY 1996 balance of \$24.2 billion.
- **Other Revenues and Financing Sources.** Line 6, Other Revenues and Financing Sources, of the Statement of Operations and Changes in Net Position for FY 1997 showed a balance of \$13.3 billion, a \$11.4 billion (45.9 percent) decrease from the FY 1996 balance of \$24.7 billion.

If large year-to-year variations are not fully explained in the financial statement footnotes, the meaning of the variances may not be properly understood. Thus, incomplete explanations of the variances reduce the usefulness of the financial statements. Failure to fully explain variances could confuse users and readers of the financial statements.

DoD Form and Content Guidance

Defense Financial Management Regulation, DoD Regulation 7000.14-R, volume 6, chapter 6, "Form and Content of Audited Financial Statements." (DoD Form and Content Guidance) was not adequate for preparing and compiling financial statements and was not provided in a timely manner.

Adequacy of DoD Form and Content Guidance. DoD Form and Content Guidance requires that amounts reported in the footnotes be consistent with corresponding amounts reported as line items of the principal statements. However, the guidance does not outline specific procedures to ensure consistent reporting between the financial statements and the footnotes, does not require that financial information reported in multiple footnotes be reported consistently, and does not require that material variances in line-items from year-to-year be explained in the financial statement footnotes. Further, the guidance does not provide procedures to remedy any instances of inconsistent or inaccurate reporting identified. Thus, the guidance was not adequate for preparing and compiling financial statements in a consistent manner.

Timeliness of DoD Form and Content Guidance. The Deputy CFO; the Director, DFAS; and the IG, DoD, agreed to responsibilities and timelines for the presentation of audited financial statements in a Memorandum of Understanding, issued June 6, 1997. Under the Memorandum of Understanding, the USD(C) was responsible for issuing DoD Form and Content Guidance. The USD(C) did not issue the FY 1997 DoD Form and Content Guidance until January 14, 1998, after the DoD Components had prepared Version 2 of the financial statements. As a result, the DoD Components received guidance too late in the compilation process to effectively prepare and accurately compile financial statements.

Additional details on the timeliness of financial reporting are discussed in the next section on "Adequacy of Financial Statement Reviews." We believe that DoD Form and Content Guidance must be available to DoD Components at least 90 days prior to the beginning of each fiscal year.

Adequacy of Financial Statement Reviews

DFAS did not perform adequate reviews throughout the compilation process to ensure consistency, accuracy, and completeness in the DoD Consolidated Financial Statements for FY 1997. The DFAS Indianapolis Center compiled the DoD Consolidated Financial Statements and footnotes based on the DoD Component financial statements supplied by the other DFAS centers. DFAS guidance issued October 27, 1997, required that the DFAS centers verify that all amounts reported on financial statements are correct and presented in accordance with DoD accounting guidance and the DoD form and content guidance. Specifically, the DFAS centers were required to correct or explain in the footnotes any material variances between line items between fiscal years and verify that all financial statements are complete and that information is reported consistently. However, DFAS did not follow this guidance.

The Memorandum of Understanding between the Deputy CFO, the Director, DFAS, and the IG, DoD, identified agreed-on timelines for financial reporting for

Compilation Process

FY 1997. Under this Memorandum of Understanding, DFAS was to provide an unaudited initial version of the DoD Consolidated Financial Statements to the IG, DoD, by December 24, 1997. The DFAS did not meet the agreed-on timelines. The DFAS Indianapolis Center did not receive all initial versions of the necessary DoD Components' financial statements in a timely manner and was unable to prepare an initial version of the DoD Consolidated Financial Statements for FY 1997. In our disclaimer of opinion, we cited the delay in preparation of the financial statements as one of the reasons we were unable to render an opinion on the DoD Consolidated Financial Statements for FY 1997.

Further, the initial versions of the DoD Component financial statements that the DFAS Indianapolis Center received, were incomplete and continually revised. Consequently, the DFAS Indianapolis Center was rushed to prepare the DoD Consolidated Financial Statements for FY 1997 and did not have time to perform adequate reconciliations between the footnotes and between the footnotes and line items to ensure consistency.

DFAS Indianapolis Center personnel stated they performed some reviews of the financial information prior to the compilation of the DoD Consolidated Financial Statements, however, they were unable to provide documentation of any such reviews. In addition, DFAS Indianapolis Center personnel stated that they raised reporting issues during the compilation process. Sometimes these issues were resolved with a phone conversation; however, no documentation of the issue or its resolution was maintained. In other instances, DFAS Indianapolis Center personnel stated they raised reporting issues to others outside of the DFAS Indianapolis Center and no action was taken. Again, no documentation was provided to show these occurrences.

Reconciliations to resolve discrepancies should be performed at each DoD reporting level by all DFAS centers. The identification of any inconsistencies or instances of improper reporting, and the resolution of any such issues should be adequately documented and maintained to support the auditability of the financial statements at each level. Further, we believe it is imperative that DFAS fully explain large variances in line-items from year-to-year in the financial statement footnotes.

Financial Statement Impact

The DoD Consolidated Financial Statements for FY 1997 were materially misstated and confusing. In addition, the inaccurate reporting at the DoD level caused misstatements in the Government-wide, "1997 Consolidated Financial Statements of the United States." Inconsistent and incomplete information can confuse financial statement readers.

DoD Consolidated Financial Statements for FY 1997. DoD did not consistently identify significant accounting policies used and did not consistently and accurately report amounts in the Consolidated Financial Statements for FY 1997. Further, DoD did not clearly and consistently support the cost of goods sold, did not show the extent of intragovernmental account balances, did not report FY 1996 comparative balances consistent with the DoD Consolidated Financial Statements for FY 1996, and understated cost of goods sold in the Consolidated Financial Statements.

The inaccurate and incomplete reporting identified caused the DoD Consolidated Financial Statements for FY 1997 to be misstated by \$10.8 billion. Specifically, Environmental Liabilities were understated by \$10.5 billion. Also, Other Liabilities (Intragovernmental) Covered by Budgetary Resources were overstated by \$312 million and Other Liabilities (Governmental) Covered by Budgetary Resources were understated by \$29.4 million, resulting in a total misstatement of \$0.3 billion.

1997 Consolidated Financial Statements of the United States. The Department of the Treasury compiled Government-wide financial statements, "1997 Consolidated Financial Statements of the United States," for the first time in FY 1997. These financial statements were based on financial information reported to the Department of the Treasury by Federal agencies through the Federal Agencies' Centralized Trial-Balance System. To supply Government-wide financial statements to the OMB by March 1, 1998, the Department of the Treasury required that Federal agencies' provide audited financial statements by February 13, 1998. In the past, lapsed timelines for financial reporting were not a significant concern for DoD. With the advent of Government-wide financial reporting, it is essential that DoD meet stated financial reporting timelines, so that the Department of the Treasury is not delayed in reporting to OMB. Inconsistent and inaccurate reporting caused \$10.5 billion understatements in the Environmental Liabilities line in the Government-wide financial statements.

Recommendations for Corrective Action

1. We recommend that the Under Secretary of Defense (Comptroller):
 - a. develop specific guidelines and procedures for reconciling financial information to ensure consistent reporting between the footnotes and the financial statements and include those guidelines and procedures in the next update to the DoD guidance on the Form and Content of Audited Financial Statements;
 - b. develop specific guidelines and procedures for identifying and explaining any large variances in financial statement line-items from year-to-year and include those guidelines and procedures in the next update to the DoD guidance on Form and Content of Audited Financial Statements; and
 - c. provide DoD guidance on the Form and Content of Audited Financial Statements to the DoD Components' at least 90 days prior to the beginning of each fiscal year.

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2. We recommend that the Director, Defense Finance and Accounting Service:
 - a. verify that the necessary reconciliations are performed and documented at each reporting level by the DFAS Centers to ensure consistent and accurate reporting throughout the financial statements each fiscal year;
 - b. verify that large variances in financial statement line-items from year-to-year are fully explained in the financial statement footnotes; and
 - c. ensure that the agreed-on timelines for financial reporting are met each fiscal year.

Management Comments Required

The Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, did not respond to a draft of this report. We request that the Under Secretary of Defense (Comptroller) and Director, Defense Finance and Accounting Service, comment on this audit report by November 23, 1998.

Part II - Additional Information

Appendix A. Audit Process

Scope

As part of our effort to determine whether the DoD Consolidated Financial Statements for FY 1997 were presented fairly in accordance with OMB guidance, we reviewed the compilation process for the consolidated financial statements at the DFAS Indianapolis Center. Specifically, we reviewed the consolidated financial statements to determine whether financial information was stated consistently, accurately, and completely throughout the principal statements and footnotes.

The footnotes to the principal statements, which are an integral part of the financial statements, provide additional disclosures necessary to make the financial statements fully informative and not misleading. For FY 1997, DoD was required to prepare 31 footnotes to the financial statements.

For FY 1997, the DoD Consolidated Statement of Financial Position reported assets of \$1.33 trillion and liabilities of \$949 billion. The Consolidated Statement of Operations and Changes in Net Position reported revenues of \$270 billion and expenses of \$295 billion.

DoD-wide Corporate Level Government Performance and Results Act (GPRA) Goals. In response to GPRA, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objectives and goals:

Objective: Fundamentally reengineer the Department and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals:

Objective: Reengineer DoD business practices and strengthen internal controls. **Goal:** Standardize, reduce, clarify, and reissue financial management policies (FM-4.1) and improve compliance with the FMFIA (FM-5.3).

General Accounting Office High Risk Area. The General Accounting Office has identified several high risk areas in the Department of Defense. This report provides coverage of the Defense Financial Management high risk area.

Methodology

We analyzed the financial statements and supporting footnotes for the FY 1997 DoD Consolidated and the DoD Component Financial Statements.* We also analyzed the accounting data for the appropriated funded Defense agencies whose data was included as part of the FY 1997 DoD Consolidated Financial Statements. Our audit included review of the procedures and policies DFAS used to compile the FY 1997 DoD Consolidated Financial Statements. We conducted interviews with DFAS personnel regarding the compilation of the DoD consolidated financial statements.

Accounting Principles. Through FY 1997, agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 94-01, as supplemented by OMB Bulletin No. 97-01. The FY 1997 hierarchy is summarized as follows:

- standards agreed to and published by the Director, OMB; the Secretary of the Treasury; and the Comptroller General;
- form and content requirements of OMB Bulletin No. 94-01;
- accounting standards contained in agency accounting policy, procedures, or other guidance as of March 29, 1991; and
- accounting principles published by other authoritative sources.

Computer-Processed Data. We could not rely on the computer-processed data used to prepare the DoD Consolidated Financial Statements for FY 1997. DoD accounting and related systems were unreliable and as such the financial statements were unauditible. DoD has candidly addressed deficiencies in its financial management systems in the Annual Statement of Assurance and the management representation letter for FY 1997. The unreliable computer-processed data was used in the preparation of the financial statements and this report because it was the only financial data available. We continue to review the adequacy of existing and proposed financial management systems.

Audit Period and Standards. We performed this financial-related audit during the period February 1998 through August 1998 in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD. Accordingly, we included tests of management controls as we considered necessary.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD. Further details are available on request.

* The DoD Consolidated Financial Statements for FY 1997 consist of the financial statements of the Army, the Navy, and the Air Force General Funds; the Army, the Navy, and the Air Force Working Capital Funds; the Defense Logistics Agency, the Defense Information Systems Agency, the DFAS, the Defense Commissary Agency, the U.S. Transportation Command, and the Joint Logistics Systems Center Working Capital Funds; the DoD Military Retirement Trust Fund; the National Defense Stockpile Transaction Fund; the U.S. Army Corps of Engineers (Civil Works) General Fund; and the Other Defense Organizations General Fund.

Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls.

Scope of Review of Management Control Program. As part of our overall objective to determine whether the FY 1997 DoD Consolidated Financial Statements were presented fairly, we also reviewed the adequacy of internal controls, which included the management control program, related to the proper reporting of assets, liabilities, revenues, expenses, and related supplementary information. We also reviewed management's self-evaluation applicable to those controls.

Adequacy of Management Controls. We identified a material weakness because the management controls over the reporting of assets on the DoD Consolidated Financial Statements were not adequate to ensure that all assets and liabilities were properly classified and disclosed. A copy of the final report will be provided to the senior official responsible for management controls in DoD.

Adequacy of Management's Self-Evaluation. DoD acknowledged in its FY 1997 Annual Statement of Assurance that material control weaknesses exist in its financial statement processes that prevent DoD from complying with all accounting standards.

Appendix B. Summary of Prior Coverage

Inspector General, DoD, Report No. 98-204, "Reporting and Disclosing Intrafund Transactions on the FY 1997 DoD-Wide Consolidated Financial Statements," September 21, 1998

Inspector General, DoD, Report No. 98-161, "Internal Controls and Compliance with Laws and Regulations for the DoD Consolidated Financial Statements for FY 1997," June 22, 1998

Inspector General, DoD, Report No. 97-182, "Internal Controls and Compliance with Laws and Regulations for the DoD Consolidated Financial Statements for FY 1996," June 30, 1997

Inspector General, DoD, Report No. 97-117, "Eliminating Entries," March 31, 1997

Inspector General, DoD, Report No. 96-161, "Compilation of FY 1995 and FY 1996 DoD Financial Statements at the Defense Finance and Accounting Service, Indianapolis Center," June 13, 1996

Appendix C. Analysis of FY 1996 Comparative Data (in thousands)

| <u>Item</u> | <u>Balance Reported in FY 1996 Footnotes</u> | <u>FY 1996 Comparative Balance Reported in FY 1997 Footnotes</u> | <u>Absolute Value Difference</u> |
|--|--|--|--------------------------------------|
| | | | |
| Note 22, Other Revenue and Financing Sources: | | | |
| Other Miscellaneous Gains | \$101,935 | \$103,518 | \$1,583 |
| Other Revenues | \$649,047 | \$647,464 | \$1,583 |
| Note 23, Program or Operating Expenses: | | | |
| Travel and Transportation | \$9,126,177 | \$8,751,248 | \$374,929 |
| Rental, Communication, and Utilities | \$4,340,683 | \$4,385,373 | \$44,960 |
| Contractual Services | \$81,700,850 | \$81,732,984 | \$32,134 |
| Supplies and Materials | \$12,694,438 | \$12,797,033 | \$102,595 |
| Other | \$13,401,689 | \$13,597,799 | \$196,110 |
| Note 25, Other Expenses: | | | |
| Inventory Losses or Adjustments | | | |
| Transfer to Property Disposal | \$736,572 | \$8,234,769 | \$7,498,197 |
| Potential Excess Inventory Loss | \$9,995,780 | \$2,494,835 | \$7,500,945 |
| Operating Materials and Supplies Variance | (\$331,655) | (\$331,966) | \$311 |
| | (\$3,152) | (\$93) | \$3,059 |
| Note 28, Non-Operating Changes: | | | |
| Other Increases | \$24,394,815 | \$24,601,013 | \$206,198 |
| Transfers-Out | \$20,080,375 | \$20,080,374 | \$1 |
| Other Decreases | \$96,154,256 | \$96,350,060 | \$195,804 |
| Net Non-Operating Changes (Transfers) | (\$5,527,851) | (\$5,517,456) | <u>\$10,395</u> |
| Total Absolute Value Differences | | | \$16,168,804 |

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Director, Accounting Policy
Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Public Affairs)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Finance and Accounting Service
Director, Defense Contract Audit Agency
Director, Defense Logistics Agency

Non-Defense Federal Organizations

Office of Management and Budget
National Security and International Affairs Division, Technical Information Center,
General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice,
Committee on Government Reform and Oversight
House Committee on National Security

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